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The reverse exchange: a tax-deferral tool

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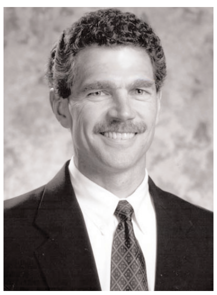

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If someone mentions a reverse exchange as a good strategy, you might think they are talking about a play the Patriots pulled. But in real estate, the reverse exchange is a form of the popular 1031 tax-deferred exchange strategy.

The reason to use a 1031 tax-deferred exchange is simple – you defer paying the capital gains taxes that would be due on the sale of a property until a later date. The federal capital gains tax is 20 percent. New Hampshire has no capital gains tax, while Massachusetts has just reinstituted a capital gains tax of 5.6 percent. If one faces a large capital gain on the sale of an investment or business property, it makes sense to consider a 1031 exchange.

The basics of a standard tax-deferred exchange are fairly easy to understand. A seller or "exchanger" wants to sell his or her property and purchase a replacement property. In order to qualify as a "simultaneous" 1031 exchange, the exchanger cannot take receipt of the proceeds from the sale of the property until the replacement property is acquired. A qualified intermediary is usually used to handle the funds during the interim. After the sale of the original property, the exchanger has 45 days to identify a potential replacement property and another 135 days (for a total of 180 days) to purchase the replacement property. This is the standard order of events of the 1031 exchange.

In a reverse exchange, the exchanger will typically use a third party who is not related to the exchanger to "park" the replacement property until the original property can be sold. After the original property is sold, the exchanger then takes title to the replacement property by buying it from the third party. Since the sequence of events is the same as the standard exchange (exchanger sells property, then takes title to replacement property) it qualifies under the IRS Section 1031 rules as a tax-deferred exchange. This is sometimes called a "parking exchange" rather than "reverse exchange," since the replacement party is "parked" with a third party while the exchanger's property is being sold.

This strategy can be especially useful to a user-owner who wants to replace his or her existing property with a new build-to-suit property. Since the user-owner is not in a position to sell and move out of the existing facility until the new facility is completed, he or she can use the parking exchange to accommodate this schedule. The user-owner would engage the services of a third-party facilitator. The facilitator will establish a parking entity that will purchase and hold the new site with a loan that is made by the user-owner. Then the user-owner will contract for the construction of their new facility with the parking entity.

As the new facility nears completion, the user-owner would then put their property on the market. Once the original property is sold, the user-owner then purchases the new facility as the replacement property from the parking entity and the exchange is complete.

This reverse exchange, or parking exchange, also is useful if an investor-owner finds an especially attractive investment property that they must move quickly on. He or she may have to close on the property in a short time frame in order to be the successful buyer. In this case, the investor-buyer would purchase the new property through the third-party facilitator, again setting up a parking entity to hold the property until the investor-owner can sell his or her original property. This allows for a reasonable marketing period for the sale of their property, allows the purchase of the attractive new property and accomplishes the tax deferral of the capital gains taxes from the sale of the original property.

While this process is more complicated than a standard exchange, it can be facilitated through the use of a professional exchange intermediary. This reverse exchange creates a number of challenges, financing being one of the main ones.

When considering a 1031 exchange one should, of course, consult with legal, tax and real estate professionals. The savings and benefits can be substantial. **NHBR**

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